Information from the Division of Health Care Finance and Policy

Quarterly Acute Hospital Financial Report, FY06 Q3

Overall profitability in FY06 Q3 improved across the board when compared to the previous quarter, and despite a slight decrease in the upper quartile, was fairly stable when compared to the same quarter last year. In addition, 77% of hospitals experienced positive Total Margins. Further, a large majority of the industry (83%) was comfortably able to meet short-term obligations, and accounts receivable and payment periods continued to improve. Finally, decreasing equity financing values indicate additional debt financing for hospitals, while the ability to cover long-term obligations remained a serious concern for 35% of Massachusetts hospitals.

About this Report

The Division of Health Care Finance and Policy (the Division) publishes quarterly acute hospital financial reports in response to a legislative mandate to provide an annual assessment of financial trends in the acute care hospital industry. Quarterly reporting is one part of the Division's ongoing program to better protect the public interest by continuously monitoring the financial condition of acute care hospitals. This report presents an industry-wide analysis from FY02 through FY06 Quarter 3 (Q3).[1,2] Financial trends for individual hospitals are on each hospital's Fact Sheet in the DHCFP Data Catalog at www.mass.gov/dhcfp.

Trends in financial ratio analysis can provide useful information about the hospital industry's financial condition. The three areas examined on a quarterly basis and discussed in this report are profitability, liquidity, and solvency.[3]

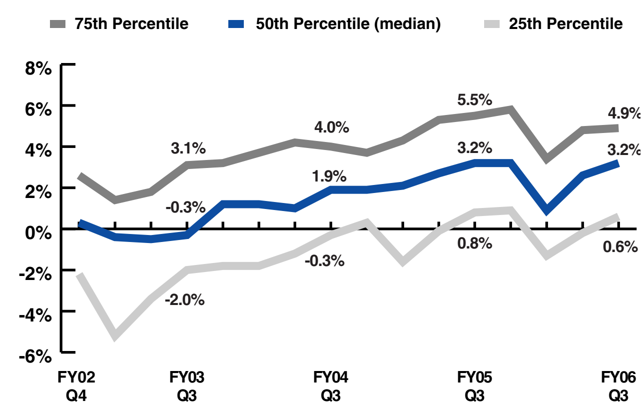
Profitability

Although most Massachusetts acute care hospitals are non-profit, they do need to generate a sufficient surplus in order to complete their missions, repay debt, and invest in the future of their organizations. Therefore, an analysis of the industry's profitability using three key ratios is reported here. Figures 1, 2, and 3 show FY02 through FY06 Q3 trends for 25th, 50th (median) and 75th quartile values[4] for Total Margin,[5] Operating Margin,[6] and Non-operating Margin.[7]

While overall profitability was slightly lower for the upper quartile when compared to the third quarter of FY05, it was fairly stable for the middle and lower quartiles, and all three quartiles improved when compared to the second quarter of FY06 (see Figures 1 through 3). Operating margin was slightly below the FY05 Q3 levels for the middle and lower quartiles, but improved in the upper quartile. All three quartiles improved when compared to FY06 Q2. Non-operating margin also improved in FY06 Q3 when compared with both the same quarter last year and the previous quarter in FY06. For reference, Figure 4 provides annual measures of total profitability.

Figure 1

Total Margin Trend by Quarter, FY02-FY06 Q3



- **Overall profitability in FY06 Q3 improved across the board compared to FY06 Q2 and was fairly stable when compared to FY05 Q3. In addition, 77% of the industry had positive margins in FY06 Q3.**

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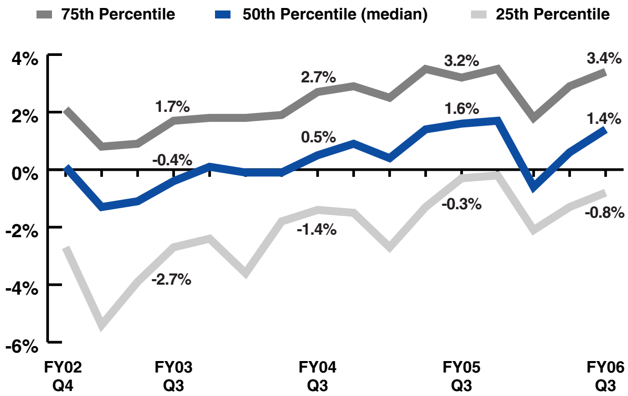
Figure 2

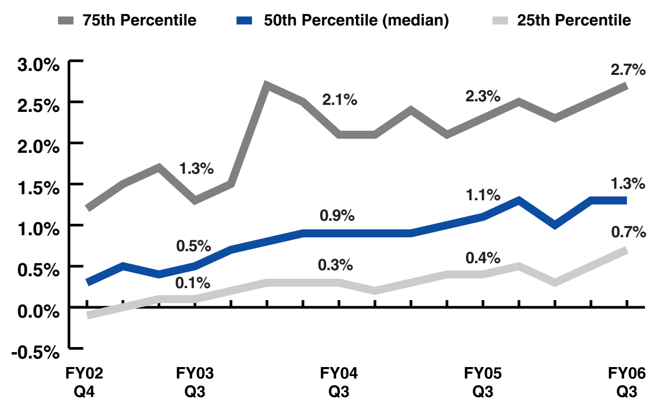
Operating Margin Trend by Quarter, FY02-FY06 Q3



- **Operating Margin improved across all three quartiles compared to FY06 Q2. It was slightly below FY05 Q3 levels for the two lower quartiles, but improved in the upper quartile.**

Figure 3

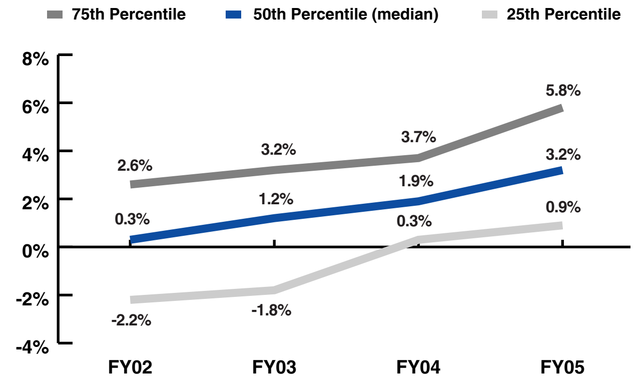
Non-operating Margin Trend by Quarter, FY02-FY06 Q3



- **Non-operating margin improved over FY05 Q3 and FY06 Q2. Only three hospitals reported non-operating losses in FY06 Q3.**

Figure 4

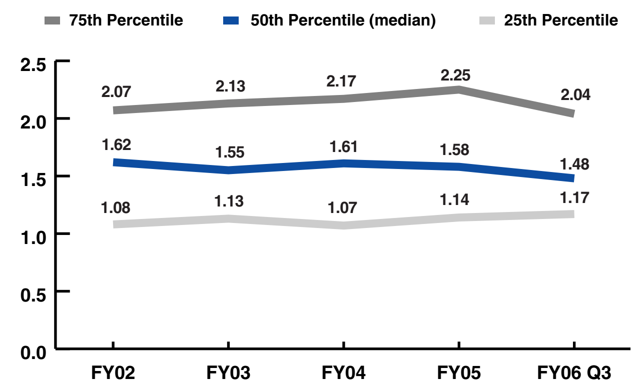
Annual Total Margin, FY02-FY05



- **Annual Margins are provided as a reference.**

Figure 5

Current Ratio Trend, FY02-FY06 Q3



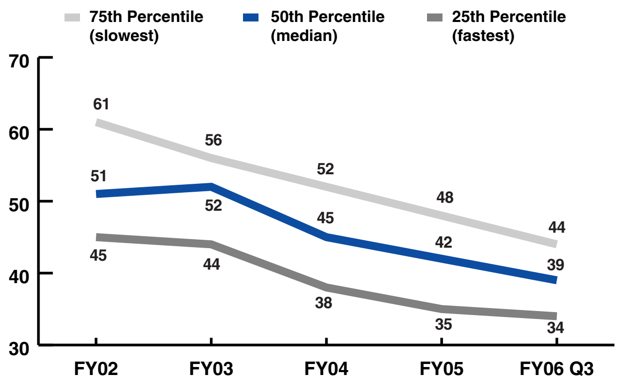
- **Current Ratio was lower for all three quartiles when compared to FY05 Q3; nevertheless, 83% of the industry maintained a Current Ratio above the 1.0 benchmark in FY06 Q3.**

Liquidity

Liquidity ratios indicate a hospital's ability to meet its short-term obligations. Deterioration of these ratios is one indication of financial stress. Three liquidity ratios are reported here: Current Ratio,[8] Average Days in Accounts Receivable (A/R),[9] and Average Payment Period.[10] Figures 5, 6, and 7 show trends in quartile values for these three ratios.

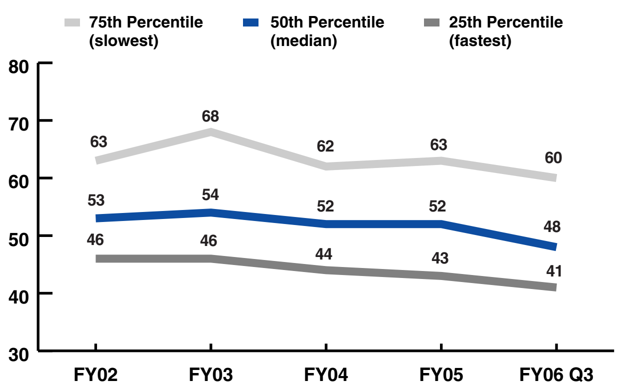
Compared to FY05, the majority of hospitals demonstrated a slightly lower ability to meet current obligations in FY06 Q3; nevertheless, a large majority (83%) of hospitals operated above the 1.0 minimum benchmark (see Figure 5).[11] In addition, all three quartiles decreased their Days in Accounts Receivable when compared to FY05. Similarly, the industry showed continued improvement across all quartiles in the

Figure 6
Days in Accounts Receivable Trend, FY02-FY06 Q3



- **Following the industry's positive trend since FY02, hospitals continued to improve collection of receivables in FY06 Q3. Median Days in A/R decreased by eight, six and four days respectively for the upper, middle and lower quartiles.**

Figure 7
Average Payment Period Trend, FY02-FY06 Q3



- **Average Payment Period also decreased across all quartiles in FY06 Q3; in addition, the percentage of hospitals paying current obligations at a faster rate than they are collecting receivables remained stable at 27%.**

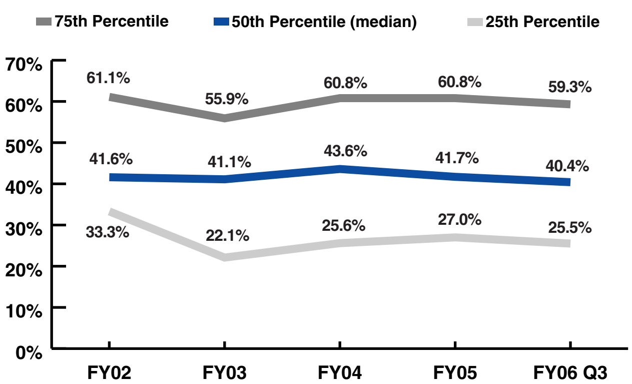
average time to pay current liabilities (Average Payment Period, see Figure 7). Finally, the percentage of hospitals paying current obligations at a faster rate than they are collecting payments remained fairly stable at 27% in FY06 Q3; this could lead to cash flow constraints for this group of hospitals in the future.

Solvency

Solvency ratios provide information regarding both how an organization finances its assets and how able an organization is to take on new debt. Deterioration of these ratios is another indication of problems in the financial health of an organization. Solvency ratios of Debt Service Coverage and Cash Flow to Total Debt are not included in this report because annualized data are necessary to accurately present these ratios. For quarterly analysis, only one solvency ratio is reported: Equity Financing.[12]

The Equity Financing ratio, measured by the proportion of total assets financed by equity, reflects the ability of a hospital to take on more debt. Low values indicate that a hospital is highly leveraged and could have difficulty securing access to debt financing for further asset acquisition. Equity financing decreased slightly for all three quartiles in FY06 Q3, but was above the benchmark for the upper and middle quartiles. The decrease may signal increased long-term debt as hospitals refurbish, add new services, and buy or lease new equipment. Equity Financing, however, was below the 30% industry benchmark for 35% of the hospitals, indicating long-term solvency issues for this group.

Figure 8
Equity Financing Trend, FY02-FY06 Q3



- **Equity Financing Ratios decreased slightly for all three quartiles in FY06 Q3, but were above the industry benchmark for the upper two quartiles. Thirty-five percent of hospitals were below the 30% benchmark. The highly leveraged position of these hospitals may make future asset acquisition difficult for this group.**

Teaching versus Non-teaching Hospitals

The Division also examines the financial health of teaching and non-teaching hospitals using financial ratio analysis. In terms of total profitability, teaching hospitals outperformed non-teaching hospitals, with a lower percentage of teaching hospitals experiencing overall losses, and all three quartiles at higher levels for teaching versus non-teaching hospitals. Twenty-eight percent of non-teaching hospitals experienced total losses in FY06 Q3 versus 6.3% for teaching hospitals. In terms of operating performance, a higher percentage of teaching hospitals (37.5%) experienced losses versus non-teaching hospitals (34%); however, all three quartiles were higher for teaching hospitals. Finally, only one teaching hospital and two non-teaching hospitals experienced non-operating losses.

With regard to liquidity, there was very little difference between the two groups, with teaching hospitals only slightly better than non-teaching hospitals. Median Current Ratio was equal for both groups. Days in A/R were slightly lower for teaching hospitals, while Average Payment Period was slightly higher. Finally, teaching hospitals fared better in terms of Equity Financing, with a higher percentage of non-teaching hospitals (38%) versus teaching hospitals (25%) falling below the industry standard, indicating that non-teaching hospitals may have more difficulty borrowing in the upcoming year.

Summary

Median Total Margin improved across the board in FY06 Q3 when compared to FY06 Q2 and remained fairly stable when compared to the same quarter last year. Current Ratio was slightly lower in the third quarter, but a large majority of hospitals (83%) were still able to meet their current obligations, and both management of receivables and Average Payment Period improved across the industry. Finally, although Equity Financing was slightly lower than FY05, indicating an increase in debt financing for asset acquisition, it was above the benchmark for the majority of the industry. Nevertheless, the ability to cover long-term obligations remained a serious concern for 35% of the industry.

Financial ratio values for each hospital are on the Hospital Fact Sheets in the Division of Health Care Finance and Policy Data Catalog at www.mass.gov/dhcfp. Hospital-specific dollar surplus or loss, net patient service revenue, total net assets, and assets whose use is limited are also provided on the Hospital Fact Sheets illustrating the magnitude of hospital surplus and loss, the size of operation, and the size of reserves.

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1 The FY06 Q3 findings in this report are based on the financial filings of 66 acute care hospitals. One hospital (Mercy Medical Center) has a fiscal year that ends on December 31st, thus FY06 Q3 data represent only the first two quarters of the fiscal year. Three hospitals (Cambridge Health Alliance, MetroWest Medical Center and Saint Vincent Hospital) have fiscal years that end on June 30; therefore these hospitals' data represent all four quarters of operation. Martha's Vineyard Hospital's fiscal year ends on March 31, thus its FY06 Q3 data represent the full fiscal year.

2 The AICPA Accounting and Audit Guide for Health Care Organizations has changed the method of accounting and auditing for Alternative Investments. Where a hospital holds a 5% or greater ownership of such investments, the hospital must report these investments using the Equity Method. The effect of using the Equity Method is that income or losses from these investments are reported as non-operating gains (losses), as opposed to a change in net assets.

3 Depending on the organization of each hospital, data may exclude other aspects of some hospitals' financial health, such as performance of endowments or the financial health of parent or other affiliated organizations.

4 Quartile values can shed light on information about the distribution of financial ratio values across hospitals. Often, averages can be materially affected by outlier/extreme values at the low and high ends of a distribution. Examining quartiles, therefore, is a preferred means of assessing the overall distribution of values across hospitals. For instance, the ratio values of one-quarter of the hospitals at the low end of the distribution will fall at or below the 25th quartile value. Similarly, the ratio values of one-quarter of the hospitals at the high end of the distribution will fall at or above the 75th quartile value. The 50th percentile is the median, or the center of the distribution of values. Half of the hospitals' financial ratio values will fall below the median, and half will fall above the median. These quartile measures are particularly useful when a distribution is markedly skewed, or where it is generally symmetrical but includes a few outliers.

5 Ratio of total income to total revenue.

6 Ratio of operating income to total revenue.

7 Ratio of non-operating income to total revenue.

8 Ratio of current assets to current liabilities.

9 Ratio of net patient accounts receivable to net patient service revenue/quarters of data * 91.25.

10 Ratio of current liabilities less estimated third-party settlements to total expenses less depreciation and amortization/quarters of data * 91.25.

11 A Current Ratio value of 1.0 indicates that a hospital has one dollar held in current assets per dollar of current liabilities. Values below 1.0 are considered strongly unfavorable and highlight an organization's illiquid position.

12 Ratio of total net assets to total assets.

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